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Corralling D&O Defense Costs:
A Necessary Partnership Between Carriers and Insureds

As the size of D&O settlements continues to escalate, there is less certainty today than ever before that a company's D&O insurance program will be sufficient to fund all losses incurred by directors and officers when allegations of wrongdoing arise. Similarly, it is far from certain that indemnification from the company will be available to pay those losses. As a result, directors and officers have a strong incentive to preserve the D&O insurance proceeds wherever possible and to partner with the insurer to assure that the D&O insurance program is depleted by only reasonable and necessary losses. In particular, directors and officers should actively participate with the insurer to manage defense costs, thereby maximizing the protection afforded by the D&O insurance program.

A cynic might summarily dismiss this premise as being the product of an insurer's obvious self-interest. Although such skepticism is understandable, this visceral reaction misses the stark reality of the post-Enron attitudes of plaintiffs' lawyers, institutional investors, judges, regulators, and the public. In today's D&O litigation environment, it is impossible to predict with any reliability what amounts will be required to ultimately resolve all claims covered under a particular policy. Not only is the magnitude of settlements in the known claims difficult to estimate, but the heightened prospect of future opt-out or other related claims which would be subject of the same limit of liability creates additional uncertainty. In other words, insured directors and officers have a very real incentive to view the D&O insurance program as their "personal asset" and to preserve policy proceeds for those unpredictable losses. If insureds continue to incur defense costs in staggering amounts, and do not aggressively manage defense costs, D&O insurance may become nothing more than a mere defense fund, leaving insured defendants underinsured or uninsured for the costs to ultimately resolve the claims.

These concerns are aggravated by the fact that defense costs continue to increase dramatically, particularly in class actions alleging violations of federal securities laws. There are many reasons for this increase, but one of the primary reasons is the defendant insureds' failure, for whatever reason, to actively manage and control their chosen counsel. Unlike many other insurance products, D&O policies typically allow defendant insureds to select their preferred defense counsel, subject to the consent of the carrier. Frequently, insured D&O defendants select "blue chip" law firms with impeccable credentials and, not surprisingly, with a corresponding top-of-the-market price tag. Unfortunately, once defense counsel is selected, the defendant insureds too often largely ignore what the law firm does and how it manages the defense efforts. In most other types of litigation against the company, strict litigation management guidelines are enforced by the company with the goal of creating a cost-efficient yet effective defense effort. Companies frequently allow D&O litigation to proceed

unencumbered by these important and useful litigation management efforts. Apparently, this result is consciously or subconsciously justified because senior executives and directors are the defendants, and others within the company do not want to create the appearance they are hindering the defense of those defendants. Ironically, though, that attitude potentially weakens the defense efforts and unnecessarily erodes valuable insurance coverage for those defendants.

Insurers, of course, seek to pay only reasonable and necessary defense costs. However, insurers have limited ability to reign in excessive or wasteful practices by defense counsel if the insured defendants, as the ultimate clients, do not support the insurer's efforts and do not independently manage the litigation process. Stated differently, defense counsel can easily ignore the insurer's requests and guidelines if defense counsel believes there are no adverse ramifications to them from doing so. Defense counsel have an obvious self-interest in charging more rather than less for their defense efforts and will naturally tend to do so absent a compelling reason to the contrary. Prudent litigation management efforts by the insurer are frequently disregarded by defense counsel as inappropriate attempts by the insurer to interfere with the defense counsel's zealous representation of their client. That excuse, though, is far less compelling when the client is the one imposing the litigation management guidelines.

Many of the more important defense management topics for insureds to address throughout the litigation are summarized below. These issues should be thoroughly discussed, and an agreement reached, with chosen defense counsel at the beginning of the case, and should be closely monitored during the course of the litigation.

1. Selection of Counsel

There is no hard and fast rule in selecting counsel to represent directors and officers. Like any other case, an insured should choose counsel who is experienced in the area of law that is the subject matter of the litigation and whom the insured trusts. Big and expensive law firms are not necessarily the best or the most likely to attain the desired results. Insureds should examine not just what prior experience counsel have in similar litigation, but what results counsel achieved. Selecting counsel is as much about subjective feelings and intangibles as it is about concrete knowledge of the law and courts.

Often directors and officers select by default the same law firm that regularly represents their company in both transactional and litigation matters. Such a selection may present ethical, practical, and strategic issues, which must carefully be analyzed at the outset of the litigation. For example, it is important to consider whether the proposed law firm was involved in the underlying transaction or provided representation in connection with disclosures that are the subject of the lawsuit. Does the firm's prior work create a conflict? Is there a possibility that plaintiffs will file a motion to disqualify counsel, thus creating an unnecessary litigation disruption and erosion of policy proceeds? Will lawyers in the defense firm be called to testify as witnesses? If any of the answers to these questions are yes, the cost of defending the litigation will likely increase, not because any potential challenges to chosen counsel have merit, but simply because of the predictable sideshow tactics that plaintiffs lawyers are apt to employ.

The location of defense counsel is an equally important consideration. More often than not, directors and officers choose a defense firm located in a major city, even though the lawsuit is located in some distant forum and even though more local counsel are sufficiently experienced to provide a high quality defense in the litigation. Local counsel is then retained to provide a limited "local presence." That local presence, however, rarely constitutes an adequate substitute for lead counsel having intimate knowledge of the local environment and attitudes, and garnering the respect of the court and local community. Directors and officers should, as a threshold matter, interview well respected lawyers in the legal community where the litigation is cited. Not only does this produce an obvious tactical advantage by, in effect, localizing the alien directors and officers, it eliminates an added layer of costs that further erode policy proceeds.

2. The Need for Separate Counsel

It is the rare case that only one insured is named as a defendant. Rather, plaintiffs routinely name as defendants virtually every officer or director marginally related to the wrongdoing alleged in the lawsuit. With increasing frequency, plaintiffs also include non-officer employees and managers, particularly where the D&O policy's definition of Director or Officer is expanded to include such personnel. The natural reaction is for each defendant to retain separate counsel. Not only does this practice dramatically increase defense costs, it suggests to the plaintiffs and the court a certain amount of division and finger pointing among the defendants.

To eliminate this unnecessary erosion of policy proceeds and to reduce the adverse optics perceived by the plaintiffs and the court, in many cases it makes sense to retain one defense counsel to represent all insureds, at least through the motion to dismiss stage. In many situations, this result is possible only if the company's general counsel or other trusted executive personally persuades the defendants that this joint representation is advisable and in their best interests. To induce reluctant D&O defendants to agree to this arrangement, the use of "shadow counsel" may be advisable. Such counsel would not make a public appearance in the lawsuit but would actively monitor the lawsuit and the lead defense counsel's efforts in light of any unique circumstances affecting only the shadow counsel's client.

3. Hourly Rates

Carriers generally recognize that the defense of a securities class action can be expensive and cannot be performed by inexpensive "insurance defense" lawyers. However, that does not mean hourly rates for the securities defense lawyers are non-negotiable. These cases are quite lucrative for any law firm, and often constitute highly coveted engagements. Therefore, law firms are generally willing to negotiate rates if they are made to realize that they may not be selected absent a meaningful reduction in rates. The insured defendants have the greatest leverage to accomplish a rate reduction, and should not accept the likely bluff from defense counsel that "we don't discount rates."

As an alternative to or in addition to negotiating a reduction of rates, insureds should consider other cost control measures, including caps on the hourly rates of partners, associates,

and legal assistants; a percentage reduction off of standard rates; flat blended rates for partners and associates; or fixed costs for discrete tasks (i.e., motion to dismiss, propounding discovery, summary judgment motion, and the like). The insured defendants should also require pre-approval of any rate adjustments by defense counsel during the life of the litigation.

4. Budgets

Corporate clients routinely require their lawyers to provide a defense cost budget in other types of litigation, but rarely require a budget in large D&O litigation. Although the nature and complexity of securities litigation make it difficult to provide a meaningful litigation budget at the outset of the case for the life of the lawsuit, budgeting in phases can provide a useful tool in managing expectations and controlling defense costs in the litigation.

Thus, insured directors and officers should consider requesting that defense counsel provide interim budgets throughout the course of the litigation. Such interim or task based budgets could be tied to, for instance, the initial investigation of the factual allegations of the claims, drafting and arguing motions to dismiss, and responding to the motion to appoint a lead plaintiff and class counsel. Thereafter, the insureds should request additional budgets for the class certification phase of the lawsuit, document and other written discovery, fact depositions, summary judgment briefing and argument, and so forth. Proposed budgets from defense counsel should be carefully scrutinized by the insureds and the insurer, and any adjustments and concerns should be discussed with defense counsel. This sort of budgeting process ensures that counsel, the directors and officers, and the insurers understand the magnitude of the expected fees, and helps operate as a check on defense counsel from greatly exceeding the budgeted amounts.

While budgets are merely estimates based on both experience in other cases and the unique factors of the lawsuit at hand, and while it is generally understood that the budget might be exceeded due to unforeseen events, the budget should have some “teeth” in order to have any impact. Accordingly, in the event that actual costs vary significantly from the budget, the insured defendants should require defense counsel to notify the carrier and the insureds promptly, explain the reasons for exceeding the budget, and supplement the budget as appropriate. Absent prior approval from the insured defendants and the carrier, and absent adequate explanation by defense counsel, any significant variance from the budget should be deemed presumptively unreasonable.

5. Staffing

Significant savings can be generated from proper staffing of the defense efforts by a law firm. Consider the following not unusual example. Two similarly situated officer defendants retain separate counsel (contrary to the request of the carrier). There are no factual or legal defenses unique to either defendant. Neither firm is designated as lead; in other words, they each pursue the same motions, discovery, etc. on behalf of their respective clients. Nevertheless, one firm’s invoices are routinely several times the amount of the other firm. Why? Staffing. One firm staffs the matter with a single partner and one or two associates

dedicated to the lawsuit for its duration. The other firm assigns to the same matter a senior partner, two junior partners, and a flock of associates who rotate in and out of the case.

Unfortunately, the leanly staffed firm in this illustration tends to be the exception, even though the quality of the representation is generally no different than those firms that staff cases with armies of lawyers. In fact, there seems to be little correlation between quantity of lawyers and quality of representation. Thus, director and officer defendants should frequently discuss with defense counsel the staffing of their case. In this regard, clients should insist on a minimum number of lawyers assigned to their case, each of whom is dedicated to the case throughout its duration. It is equally important in this regard to emphasize that rotating lawyers through the case is unacceptable.

An increase in defense costs also occurs when junior level tasks are performed by senior level professionals. Partners should not generally conduct legal research (i.e., performing associate level work), and associates should not coordinate court filings (i.e., performing paralegal or secretarial work). Each professional assigned to the matter should have a clearly identified role which is appropriate in light of that professional's level of experience and hourly rate.

Insured defendants should also obtain a commitment from defense counsel at the outset of the litigation to avoid multiple professionals performing the same task. For example, unless absolutely necessary, defense counsel should not have multiple lawyers attend the same hearing, deposition or meeting. When different insured defendants retain separate defense counsel, the company should attempt to arrange an efficient joint defense arrangement whereby the separate counsel divide and share among themselves appropriate common defense tasks such as researching common legal issues, attending and conducting common depositions, reviewing document discovery, etc. To address concerns regarding possible waiver of the attorney-client privilege arising from these joint representation efforts, the defendants and their counsel can sign a joint defense agreement which recognizes the defendants' common interests and which expressly preserves all applicable privileges and similar doctrines.

6. Efficiency

As noted above, directors and officers typically select as defense counsel well-known firms who routinely defend clients in complex securities class action cases. Directors and officers should insist on obtaining the benefit of that expertise, and refuse to pay for counsel to "re-invent the wheel."

Too often, however, defense firms submit invoices for exhaustive legal research on issues that recur regularly in the typical securities class action. Instead of simply updating and using the research memorandum created in another case, defense counsel will re-research the common issues at considerable costs. That practice should not be tolerated from experienced class action defense counsel. Similarly, clients should refuse to pay for exhaustive revisions to pleadings and other written documents, and should limit the number of lawyers who have input in the drafting process. Drafting "by committee" is rarely effective, but always expensive.

Cost efficiency opportunities also arise with respect to use of expert witnesses or consultants. It is recognized that experts retained in connection with securities fraud cases are expensive. Most expert testimony in securities fraud cases is highly specialized, esoteric, and complex. Nevertheless, clients should not simply divorce themselves from decisions regarding expert witness retention and cede total authority to defense counsel. Rather, clients (as well as the insurers) should pre-approve all experts and consultants that defense counsel proposes to retain and insist that each expert has a well-defined issue or issues on which to opine. And, because statistically the majority of securities fraud cases settle and never go to trial, always question defense counsel as to whether it is necessary to retain the expert (and incur the cost associated therewith) at the present time.

7. Billing Invoices

It seems obvious that clients should require defense counsel to provide monthly invoices itemized daily for each attorney, but such billing practices are not always followed. Block billing (i.e., non-itemized invoices) should not be accepted by the insureds because it is virtually impossible to determine what services were performed and what is a reasonable cost for those services. Instead, clients should require that each attorney itemize their time on a daily basis, clearly explaining the task performed and the amount of time spent on each separate task. Most large companies now require such detailed billing for other types of litigation, and directors and officers should likewise insist upon the same level of detail.

Other billing requirements should be imposed to facilitate a critical evaluation of the invoices. For example, it is helpful to require a summary at the end of the invoice of total hours billed for each attorney for the given month, each attorney's hourly rate, and the total monthly charges attributed to that attorney's services. Expenses should be itemized, and there should be a clear understanding at the outset of the litigation as to what expenses are appropriately charged to the client (as opposed to those that are more appropriately deemed part of a law firm's overhead).

Do not rely on the carrier to review and critique the invoice. The insured defendants tend to have more sway with defense counsel, and should actively be involved in evaluating the reasonableness of counsel's invoices. Perhaps most important, defense counsel should be informed that their client is critically evaluating each of the invoices. The insureds should ask questions about services that appear unreasonable or unnecessary. In conjunction with the carrier, questionable services should not be paid until counsel provides an explanation as to why the services were reasonable and necessary.

8. Exit Strategy

The goal of any defense effort is to get out of litigation in the most cost-effective manner possible. From the beginning of the case, insureds should constantly have a viable, cost effective exit strategy to work towards, although the strategy may obviously change based on developments in the litigation. Defense counsel should be involved in developing and re-evaluating that strategy and should be held partially accountable for its implementation.

Too often, however, defense counsel at the early stages of litigation will tout to the insureds and carrier the strong defenses to and weaknesses of plaintiff's claims, thereby inducing the insureds and carrier to invest large amounts in defense of the claims, then later announce that the case is too risky to take to a jury and must be settled. If settlement is the recognized exit strategy from the beginning of the case, and the litigation is actually managed to that end, frequently far less need be invested in defense costs, thus resulting in either more insurance money being available to fund any settlement or reducing the litigation's total cost.

9. Coordination with the D&O Insurer

D&O insurers have significant experience in overseeing the management of complex claims. Insureds should seek out the input of their carriers and work cooperatively with the insurers throughout the litigation. Insureds should require that defense counsel provide regular reports to the insureds and the carrier. Those reports should provide more than just a status update, but should detail what defense counsel is presently doing, identify important issues, and address progress toward achieving the agreed-to exit strategy. These reports can be in writing; often, however, it makes sense to convene periodic conference calls or meetings so that an active interchange of ideas can be achieved.

Issues of privilege and confidentiality should not prevent this open communication with the carrier. Carriers routinely enter into confidentiality or joint defense agreements with the insureds to hurdle this concern. Moreover, the insureds can request from counsel for plaintiffs an agreement that they will not contend that any privilege or confidentiality is waived by communicating with the carrier. Plaintiffs typically grant these requests because they realize the insurance policy will likely be one of plaintiffs' primary sources of recovery and an informed insurer will more likely authorize a settlement payment.

Insureds should provide their carrier with the monthly invoices of defense counsel even though the self-insured retention might not yet be exhausted. It is important to allow the carrier to monitor even the early stages of the litigation and the depletion of the retention. Also, consistent with the consent and cooperation requirements in the D&O policy, insureds should involve the insurer in all facets of the defense efforts, including each of the litigation management opportunities summarized above. Building such a close and cooperative relationship both allows the insureds to benefit from the insurer's considerable experience in this type of litigation and minimizes the risk that the insurer will be surprised when the insureds seek large payments from the insurer to settle the litigation.

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Dan A. Bailey is the Chair of the Firm's Directors & Officers Liability Practice Group and represents and consults with directors and officers, corporations, insurance companies, and law firms across the country. In addition to advising Boards and drafting most of the D&O insurance policies in the market, he has represented clients or served as an expert witness in many of the largest D&O claims for more than 30 years. He is co-author of Liability of Corporate Officers and Directors, a leading treatise on the topic, has published dozens of articles and speaks at more than 20 seminars a year on the subject.

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